Nos. 12,618 and 12,619

In the United States Court of Appeals for the Ninth Circuit

MOLLY A. HARKNESS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

FLOYD J. HARKNESS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The opinion of the Tax Court (R. 250-281)[1] is reported at 13 T.C. 1039.

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[1] References designated "R" are to the record in No. 12,618, while references designated "RR" are to the record in No. 12,619. The petitioners are a husband and wife who filed their returns on the community property basis. The cases present a common question, and were consolidated for hearing and opinion below. (R. 250.) By stipulation of the parties approved by this Court, the appeals have also been consolidated for purposes of briefing, argument and opinion. (R. 316-317; RR. 47.)

JURISDICTION

These petitions for review (R. 285-303; RR. 16-34) involve federal income and victory taxes for the year 1943. The Commissioner's notices of deficiency were mailed to the taxpayers on August 21, 1947. (R. 9, RR. 12.) Within ninety days thereafter, and on November 10, 1947, taxpayers filed petitions with the Tax Court for redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code. (R. 28, RR. 9.) The decisions of the Tax Court sustaining the deficiencies were entered February 15, 1950. (R. 284, RR. 15.) The cases are brought to this Court by petitions for review filed May 12, 1950 (R. 304, RR. 35), pursuant to the provisions of Section 1141(a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948. The cases were consolidated for hearing before the Tax Court (R. 250) and have been consolidated for briefing, hearing, and opinion by this Court. (R. 316-317, RR. 47).

QUESTION PRESENTED

Whether the record warrants the Tax Court's conclusion that taxpayers' children were not their partners for federal income tax purposes during the taxable year 1943, and hence that the shares of the 1943 business income attributed to the children were includible in taxpayers' gross incomes as defined in Section 22(a) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*.

STATEMENT

The facts as stipulated (R. 30-36) and found by the Tax Court (R. 250-273) may be summarized as follows:

Taxpayers, husband and wife, are residents of California and filed their income tax returns on the community property basis. They have a son who was twenty-five years old in 1943, the taxable year here involved, and a daughter who was then twenty-three years old. From 1937 until the end of 1942, the taxpayer, Floyd J. Harkness,[2] carried on, as sole proprietor, the business of growing and shipping fruits under the name of United Packing Company. The main office of the business was at Fresno, California, but its operations covered a large area in the San Joaquin Valley. The net income of the business for 1942 and 1943 amounted to $141,790 and $361,582, respectively. (R. 250-251, 271-272.)

The son graduated from college in June of 1941. From 1934 until his graduation he had worked in his father's business during summer vacations, and in 1937 he quit school for six months to help his father. For about six months after his graduation he was a full-time employee at a salary of $150 per month plus a bonus of about $910. In January of 1942 he entered the Air Corps, where he remained until 1946, and at the close of 1942 he still had a salary credit on the books of the business of $1,412.05. He owned no substantial property outside of these earnings. (R. 252, 270-271.)

[2] The term "taxpayer," whenever appearing herein, has reference to petitioner Floyd J. Harkness. His wife is a petitioner only because the returns were filed on a community property basis.

The daughter graduated from college in June of 1942. During summer vacations she had occasionally performed secretarial services for her father. Shortly after her graduation she married one Colgate, who was then serving in the Army, and from then until October of 1944 she spent her time housekeeping for her husband at various military posts. Throughout the taxable year (1943) she and her husband were stationed at Columbus, Ohio. She owned no significant amount of property. (R. 252-253.)

In the fall of 1942 taxpayer decided to convert his business from a sole proprietorship to a partnership composed of his wife, son and daughter. The primary reason was to obtain the future services of his son and son-in-law. He was well aware that neither would be available for the duration of the war, and that he would be the only active partner in the meantime, but he hoped to obtain their services after they left the Army. He also felt that if he made his children partners they would be willing to leave their share of the profits in the business. Tax saving was only a secondary consideration in his decision to form the partnership. (R. 253-256, 275-276.)

In November of 1942 a certificate of co-partnership was executed by taxpayer, his wife, and their son and daughter, and the certificate was filed with the county recorder. It stated that the four were partners carrying on business under the name of United Packing Company, and that taxpayer was the general manager in full charge of all business operations. On December 31, 1942, a partnership agreement was drafted and on the following day taxpayer and his wife transferred to the

partnership most of the assets and some of the liabilities of the business theretofore carried on by taxpayer as sole proprietor, resulting in a net worth of $138,241.61 for the partnership on that date. The two children each bought a one-fourth interest in the business for $34,-560.41 (equivalent to one-fourth of the net worth) in exchange for their unsecured promissory notes to taxpayer. The son used $1,392.05 of the credit he had earned as compensation for prior services to reduce his note. These transactions were reflected on the books of the business. A few days later, pending the execution of a formal partnership agreement, the parties signed a supplemental agreement which provided that taxpayer was to receive a salary of 75 per cent of the first $100,000 of the business net income as general manager of the partnership, and that the remaining profits were to be divided equally among the partners. The agreement stated that this division was agreed upon "on account of the fact that he [taxpayer] is the only active co-partner in said business at this particular time and will continue as such during the duration of the present war." (R. 256-259.) A formal partnership agreement, dated as of December 31, 1942, was signed by the parties in March of 1943. Its execution was delayed because objections to certain provisions in the original draft had been raised by the daughter. (R. 257-259.)

The partnership agreement provided, among other things, that taxpayer and his wife "sell, convey and set over, an undivided one-fourth partnership interest" to each of their children, the "purchase price" to consist of a promissory note from each child to taxpayer equal

to one-fourth of the net worth of the business. Taxpayer was to be "the general manager * * * in full charge of all business operations", with "the full right to conduct the business of said co-partnership in such manner as he may desire." In consideration of his services taxpayer was to receive a percentage of the net profits to be agreed upon by the parties, the balance of the profits to be divided equally. Any profits to which the children became entitled were to be applied first in payment of the promissory notes given by them to taxpayer as the purchase price of their partnership interests. Taxpayer was to use "his own good judgment and best efforts and experience in carrying on said business for the best interests of all parties", while the other partners "shall not devote any time or attention in carrying on said business unless hereafter agreed upon." Taxpayer was to "have complete charge" of the books and records, and "full charge of the collections and expenditures" of the business. Moreover, "all of the business transactions of [taxpayer] * * * in carrying on said business shall be binding on all of the said co-partners." Taxpayer was to render on the first of each year a full accounting of profits or losses. In case of any misunderstanding regarding taxpayer's conduct of the business, the decision of taxpayer and one other partner was to be binding, and if dissatisfied the other partners could bring proceedings to dissolve the partnership. (R. 259-269.)

The formation of the partnership produced no change in the conduct of the business during the taxable year 1943. The business remained, as before, completely under taxpayer's control. The daughter performed no

services, nor did she participate in the management of the business during 1943; she and her husband lived at Columbus, Ohio, throughout that year and until October, 1944. The son was stationed at Hamilton Field, California, throughout 1943, and frequently visited the company's office on week-ends. He was unable to participate in the business, but on these visits discussed its problems with taxpayer. He went overseas in December of 1943 and did not return until 1946. (R. 30-31, 252-253, 270-271.)

The net income of the business for 1943 amounted to $361,582. In accordance with the agreement taxpayer received the first $75,000 as salary, and the remaining profits were credited on the books to the four partners in equal shares of $71,645.50 each. The shares credited to the son and daughter were first applied in payment of the notes they had given to taxpayer for their partnership interests. The balance of the daughter's share was used to pay taxes and for personal expenditures. The balance of the son's share (except for $331 withdrawn in 1944) was left in the business and added to his capital account. (Ex. 6-F to Stip., R. 61, 65; R. 271.)

A partnership return was filed for the year 1943 in which $75,000 of the net income of the business was reported as compensation paid to taxpayer, and the balance as distributable to the four partners in equal one-fourth shares of $71,645.50 each. Taxpayer and his wife filed separate individual income tax returns on the community property basis, each reporting one-half of the total income they together received, or $109,145.50 each. The Commissioner determined that

the children were not partners for federal income tax purposes and that the total net income of the business for 1943 was taxable to taxpayer and his wife on a community property basis, and computed deficiencies accordingly. (R. 271-273.) The Tax Court, on the basis of all the evidence, found that the parties had no intention to join together in conducting the business as partners in 1943, and sustained the Commissioner's determination. (R. 273-280.)

SUMMARY OF ARGUMENT

In concluding that taxpayer's children were not partners for tax purposes during the taxable year 1943, the Tax Court followed the principles prescribed by the Supreme Court in the *Tower, Lusthaus,* and *Culbertson* cases, and applied by this and other Courts in a multitude of other family partnership cases. The issue is who earned the business income during the taxable year, and that depends on whether taxpayer and his children really intended to and did join together in carrying on the business as partners in that year. Unless the arrangement produces a substantial change in the management and conduct of the business, it is without economic reality and amounts in substance to but a reallocation of the business income without any change in its creation. It is also settled that whether the claimed partnership has economic reality presents a question of fact in each case, no single factor being conclusive, and that the Tax Court's determination should not be disturbed unless clearly erroneous. While no single factor is decisive, nevertheless (as held in *Culbertson*) lack of a contribution of new capital or of vital addi-

tional services or of a change in management places a heavy burden of proof on the taxpayer. Where the claimed partnership is predicated upon a gift of a portion of the taxpayer's business capital to a member of his family, or as here on a "sale" of some of the capital in exchange for notes payable out of the business profits, the transferee does not become the true owner of the transferred capital, and hence a true partner for tax purposes, unless he exercises control over the capital by participating in the management of the business. That the transferee participates in management of the business or contributes vital services to the business in a later year does not suffice to make him a partner during the taxable year.

As is plain from its opinion, the Tax Court applied these established principles. On the basis of all the evidence, including the agreement and conduct of the parties, it concluded that taxpayer and his children did not really intend to join together in carrying on the business as partners during 1943. Far from being erroneous, as taxpayer contends, this conclusion is amply supported by the record. The formation of the partnership was based upon (1) a sale by taxpayer to his children of portions of the capital already invested in the business by him, in exchange for the children's notes payable out of the shares of the profits ascribed to them as partners; and (2) the expectation that one of the children (the son) would participate in management and contribute vital services in future years, after his discharge from the Army. The sale and contemporaneous admission of the children as partners produced no change in the conduct of the business and the earn-

ing of its income during the taxable year. The business was conducted and its income was earned by taxpayer during that year in the same way as before, when he was the sole proprietor. The only difference was that portions of the income were allocated to the children. The agreement served no business purpose during the taxable year, since nothing was added to the business by way of capital or services or management. Cumulative support for the Tax Court's conclusion is furnished by the fact that the shares of the 1943 profits attributed to the children as partners were not distributed to them, but were applied in payment of their notes to taxpayer and retained in the business.

Taxpayer's elaborate argument reduces itself simply to the contention that the sale of some of his capital to his son and daughter, with the expectation of the son's participation in the business in years subsequent to the taxable year, suffices *per se* to render both children partners for tax purposes during the taxable year here involved. The contention runs counter to the Supreme Court's holding in the *Lusthaus* case, and indeed is substantially the same argument as was advanced by the taxpayer and rejected by the Supreme Court in the *Culbertson* case. Even assuming the argument were sound as to the son, it has no applicability as to the daughter who did not participate in the business even in later years. This case is essentially no different from the numerous family partnership cases in which an intra-family sale or gift of a portion of the taxpayer's capital has been held ineffectual to render the transferee his partner for tax purposes. To hold that the Tax Court was obliged to accord tax effect to the in-

stant arrangement would sanction the very type of formalism repeatedly condemned by the Supreme Court and by this and other Courts in like cases.

ARGUMENT

The Record Fully Supports the Tax Court's Conclusion That Taxpayer's Children Were Not His Partners for Tax Purposes During the Taxable Year 1943

The sole question presented is whether taxpayer's son and daughter were his partners for federal income tax purposes during the taxable year 1943. The material evidentiary facts are not in dispute. Prior to 1943 taxpayer carried on, as sole proprietor, a fruit packing business in southern California. At the end of 1942 he (and his wife, who owned the business assets in community with him) transferred a one-fourth interest in the business assets to each child, in exchange for promissory notes of the children payable out of the business profits, and contemporaneously entered into a partnership agreement with the children. (R. 251-262.) The agreement provided that taxpayer was to be the "general manager" of the business, "in full charge of all business operations", with the "full right to conduct the business of said co-partnership in such manner as he may desire." (R. 262-263.) The arrangement produced no change in the control and conduct of the business during the taxable year. Taxpayer continued, as before, to manage and carry on its affairs. The children contributed no new capital, did not participate in management, and performed no services during the taxable year. (R. 270-271, 274-280.) The son graduated from college in 1941, worked as a sal-

aried employee of taxpayer for the next six months, joined the Air Force at the beginning of 1942, and throughout the taxable year 1943 continued to serve in the Air Force. The daughter graduated from college in 1942, married shortly thereafter, and throughout the taxable year lived with her husband in Ohio. (R. 30-31, 252-253, 270-271.) On the basis of the entire record, the Tax Court concluded that (R. 274-275, 280):

> we are convinced that there was no intent on the part of the four alleged partners to join together in the present conduct of United Packing Co. in 1943.
>
> *   *   *   *   *
>
> On the basis of all the evidence we believe that the three Harknesses and Harriet Colgate had no present intent but rather an indefinite future plan to operate United Packing Co. as a genuine partnership when the partnership papers were drawn up and thus we conclude and found as a fact that the Harkness children were not bona fide partners in 1943 within the meaning of *Commissioner* v. *Culbertson, supra.*

We submit that the Tax Court applied the correct principles, and that its conclusion is fully supported by the record. This case is essentially no different from numerous other family partnership cases in which a gift or sale of some of the taxpayer's business capital has been held ineffectual to render the transferee a real partner for tax purposes.

A. *The applicable principles.*

The controlling principles were enunciated in *Commissioner* v. *Tower,* 327 U. S. 280, and *Lusthaus* v. *Commissioner,* 327 U. S. 293, were reaffirmed in *Commissioner* v. *Culbertson,* 337 U. S. 733, and have been applied by this Court [3] and other courts [4] in a legion of family partnership cases. "The issue is who earned the income and that issue depends on whether this husband and wife [here a father and children] really intended to carry on business as a partnership." *Commissioner* v. *Tower, supra,* p. 289. As stated in the *Culbertson* case (p. 742), the test is "whether, considering all the facts * * * the parties in good

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[3] *Nordling* v. *Commissioner,* 166 F. 2d 703, certiorari denied, 335 U.S. 817; *Quon* v. *Commissioner,* 165 F. 2d 215 (affirming *per curiam* 6 T.C.M. 348), certiorari denied, 334 U.S. 845.

[4] See *e.g.,* First Circuit: *Barrett* v. *Commissioner,* decided November 13, 1950 (1950 C.C.H., par. 9501); Second Circuit: *Morrison* v. *Commissioner,* 177 F. 2d 351; *Fletcher* v. *Commissioner,* 164 F. 2d 182, certiorari denied, 333 U.S. 855. Third Circuit: *Morano* v. *Commissioner,* 175 F. 2d 555, certiorari denied, 338 U.S. 904; *Eisenberg* v. *Commissioner,* 161 F. 2d 506, certiorari denied, 332 U.S. 767; *Schaeffer* v. *Commissioner,* 174 F. 2d 827; *Davis* v. *Commissioner,* 161 F. 2d 361; *Lusthaus* v. *Commissioner,* 149 F. 2d 232, affirmed, 327 U.S. 293; *Sweigard* v. *Commissioner,* 149 F. 2d 646. Fourth Circuit: *Ritter* v. *Commissioner,* 174 F. 2d 377, rehearing denied July 6, 1949; *Moore* v. *Commissioner,* 170 F. 2d 191, certiorari denied, 337 U.S. 956; *Economos* v. *Commissioner,* 167 F. 2d 165, certiorari denied, 335 U.S. 826; *Wilson* v. *Commissioner,* 161 F. 2d 556, certiorari denied, 332 U.S. 769; *Mauldin* v. *Commissioner,* 155 F. 2d 666; *Hash* v. *Commissioner,* 152 F. 2d 722, certiorari denied, 328 U.S. 838; *Stanback* v. *Robertson,* 183 F. 2d 889; *Collamer* v. *Commissioner,* decided November 8, 1950 (1950 C.C.H., par. 9498). Fifth Circuit: *Scherf* v. *Commissioner,* 161 F. 2d 495, certiorari denied, 332 U.S. 810; *Benson* v. *Commissioner,* 161 F. 2d 821; *Belcher* v. *Commissioner,* 162 F. 2d 974, certiorari denied, 332 U.S. 824; *Mead* v. *Commissioner,* 131 F. 2d 323, certiorari denied, 318 U.S. 777; *Argo* v. *Commissioner,* 150 F. 2d 67, certiorari denied, 326 U.S. 762; *Sewell's Estate* v. *Commissioner,* 151 F. 2d 806, certiorari denied, 327 U.S. 805; *Sewell* v. *Commissioner,* 151 F. 2d 765, certiorari denied, 327 U.S. 783; *Dawes* v. *Allen,* 157 F. 2d 518; *Blalock* v. *Allen,* 151 F. 2d 927; *Morton* v. *Thomas,* 158

faith and acting with a business purpose intended to join together in the present conduct of the enterprise." Whether the claimed partnership meets that test presents a question of ultimate fact in each case. *Nordling* v. *Commissioner,* 166 F. 2d 703 (C. A. 9th), certiorari denied, 335 U. S. 817. While no single factor is conclusive, nevertheless (*Commissioner* v. *Culbertson, supra,* p. 744):

> Unquestionably a court's determination that the services contributed by a partner are not "vital" and that he has not participated in "management and control of the business" or contributed "original capital" has the effect of placing a heavy burden on the taxpayer to show the bona fide intent of the parties to join together as partners.

In the *Tower* case a valid and irrevocable gift by a husband to his wife of a portion of his business capital was held ineffectual to render the wife a partner for tax

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F. 2d 574, certiorari denied, 330 U.S. 834. Sixth Circuit: *Denison* v. *Commissioner,* 180 F. 2d 938; *Nelson* v. *Commissioner,* 177 F. 2d 203; *Houghland* v. *Commissioner,* 166 F. 2d 815, certiorari denied, 334 U.S. 846; *Dawson* v. *Commissioner,* 163 F. 2d 664; *Lowry* v. *Commissioner,* 154 F. 2d 448, certiorari denied, 329 U.S. 725; *Lorenz* v. *Commissioner,* 148 F. 2d 527, certiorari denied, 327 U.S. 786; *Thorrez* v. *Commissioner,* 155 F. 2d 791; *Camfield* v. *Commissioner,* 154 F. 2d 1016; *Livie* v. *Commissioner,* 155 F. 2d 728; *Ewing* v. *Commissioner,* 157 F. 2d 679; *DeKorse* v. *Commissioner,* 158 F. 2d 801; *Greenberg* v. *Commissioner,* 158 F. 2d 800; *Schreiber* v. *Commissioner,* 160 F. 2d 108; *MacDonald* v. *Commissioner,* 165 F. 2d 213; *Epps* v. *Commissioner,* 164 F. 2d 482. Seventh Circuit: *Appel* v. *Smith,* 161 F. 2d 121; *Tinkoff* v. *Commissioner,* 120 F. 2d 564. Eighth Circuit: *Kohl* v. *Commissioner,* 170 F. 2d 531, certiorari denied, 337 U.S. 956; *Doll* v. *Commissioner,* 149 F. 2d 239, certiorari denied, 326 U.S. 725; *Supornick* v. *Commissioner,* 150 F. 2d 110; *Tyson* v. *Commissioner,* 146 F. 2d 50. Tenth Circuit: *Trapp* v. *United States,* 177 F. 2d 1; *Earp* v. *Jones,* 131 F. 2d 292, certiorari denied, 318 U.S. 764; *Grant* v. *Commissioner,* 150 F. 2d 915; *Bradshaw* v. *Commissioner,* 150 F. 2d 918; *Losh* v. *Commissioner,* 145 F. 2d 456.

purposes, where she neither participated in management nor contributed services. The Supreme Court held (p. 292) that the record furnished "more than ample evidence to support the Tax Court's finding that no genuine union for partnership business purposes was ever intended and that the husband earned the income." In the *Lusthaus* case it held that a valid sale by a husband to his wife of a portion of his capital did not suffice to make the wife a partner in the tax sense, notwithstanding that she also rendered services, and it approved the Tax Court's determination that (p. 297) "the partnership arrangements were merely superficial, and did not result in changing the husband's economic interest in the business." In the *Culbertson* case, involving a claimed father-sons partnership, the Supreme Court reversed the Court of Appeals (which had reversed the Tax Court's refusal to recognize the partnership), and remanded the case to the Tax Court (p. 748)[5]—

> * * * for a decision as to which, if any, of respondent's sons were partners with him in the operation of the ranch during 1940 and 1941. As to which of them, in other words, was there a bona fide intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of

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[5] In the *Culbertson* case the Tax Court had considered only "original capital" and "vital services" in testing the reality of the partnership. The Supreme Court held (p. 744, fn. 14) that the Tax Court should have considered "management and control," a factor equally emphasized by it in the *Tower* case. It stated (p. 747) that "If the donee of property who then invests it in the family partnership exercises dominion and control over that property" he "may" become its true owner, and hence a true partner, for tax purposes.

> capital of which they were the true owners, as we have defined that term in the *Clifford, Horst* and *Tower* cases?

The rationale of the Supreme Court's decisions in *Tower, Lusthaus,* and *Culbertson,* is that the Tax Court is not obliged to accord tax effect to a legally perfect family partnership arrangement which produces no substantial change in the creation of the business income, but merely a reallocation of it within the family. "The statutes of Congress designed to tax income actually earned because of the capital and efforts of each individual member of a joint enterprise are not to be frustrated by state laws which for state purposes prescribe the relations of the members to each other and to outsiders." *Commissioner* v. *Tower, supra,* p. 288; see also *Commissioner* v. *Culbertson, supra,* pp. 739-740.

In reiterating the principles enunciated by it in the *Tower* case, the Supreme Court in *Culbertson* stated (pp. 739-740):

> In the *Tower* case we held that despite the claimed partnership, the evidence fully justified the Tax Court's holding that the husband, through his ownership of the capital and his management of the business, actually created the right to receive and enjoy the benefit of the income and was thus taxable upon that entire income under §§ 11 and 22(a). In such case, other members of the partnership cannot be considered "Individuals carrying on business in partnership" and thus "liable for income tax . . . in their individual capacity" within the meaning of § 181. If it is conceded that some of the partners contributed neither capital nor services to the partnership during the tax years

> in question, as the Court of Appeals was apparently willing to do in the present case, it can hardly be contended that they are in any way responsible for the production of income during those years. The partnership sections of the Code are, of course, geared to the sections relating to taxation of individual income, since no tax is imposed upon partnership income as such. To hold that "Individuals carrying on business in partnership" include persons who contribute nothing during the tax period would violate the first principle of income taxation: that income must be taxed to him who earns it.

Furthermore, the Supreme Court in *Culbertson* made it clear (pp. 738-740) that a donee or vendee of a portion of the business capital does not become a partner during the taxable year merely because it is intended that he will contribute vital services or participate in management in a future year. In that case the taxpayer in 1939 sold interests in his ranching business to his four sons in exchange for their notes. All of the sons had performed services on the ranch since they were youngsters. During the taxable years (1940-1941) the eldest son continued, as before, to serve as foreman of the ranch. The second son finished college in 1940, went directly into the Army, and remained there during the taxable years. The two younger sons were still attending school, but worked on the ranch during summers and week-ends. The Tax Court refused to recognize any of the sons as partners for tax purposes. The Court of Appeals reversed on the ground that the sale of portions of the taxpayer's capital to the sons, made with the good faith expectation of the sons' future serv-

ices, required recognition of the sons' claimed partnership status. In reversing the Court of Appeals and remanding the case to the Tax Court,[6] the Supreme Court stressed that the basic question is who earned the income during the taxable year, not who expects to earn it in future years. It stated (pp. 738-740):

> The Court of Appeals, on the other hand, was of the opinion that a family partnership entered into without thought of tax avoidance should be given recognition taxwise whether or not it was intended that some of the partners contribute either capital or services during the tax year and whether or not they actually made such contributions, since it was formed "with the full expectation and purpose that the boys would, in the future, contribute their time and services to the partnership." We must consider, therefore, whether an intention to contribute capital or services sometime in the future is sufficient to satisfy ordinary concepts of partnership, as required by the *Tower* case. * * *
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> * * * * *
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> Furthermore, our decision in *Commissioner* v. *Tower, supra,* clearly indicates the *importance of participation in the business by the partners during the tax year.* We there said that a partnership is created "when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and where there is community of interest in the profits and losses." This is, after all, but the application of an often

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[6] Upon the remand the Tax Court took additional evidence and, applying the principles expressed by the Supreme Court, held that none of the sons were partners for tax purposes during the taxable years. (9 T.C.M. 647.)

> iterated definition of income—the gain derived from capital, from labor, or from both combined—to a particular form of business organization. A partnership is, in other words, an organization for the production of income to which each partner contributes one or both of the ingredients of income—capital or services. *Ward* v. *Thompson,* 22 How. 330, 334 (1859). The intent to provide money, goods, labor, or skill sometime in the future cannot meet the demands of §§ 11 and 22(a) of the Code that he who presently earns the income through his own labor and skill and the utilization of his own capital be taxed therefor. *The vagaries of human experience preclude reliance upon even good faith intent as to future conduct as a basis for the present taxation of income.* (Italics ours.)

In *Ritter* v. *Commissioner,* 174 F. 2d 377 (C.A. 4th), the taxpayer had agreed to make his son a partner and, after the son graduated from college, transferred a portion of his business capital to the son and entered into a partnership agreement with him. The son was prevented from immediately participating in the business, because he entered military service shortly after his graduation. In affirming the Tax Court's refusal to recognize the son as a partner for tax purposes, the court stated (p. 378):[7]

> But whatever may have been the intention of father and son, and whatever may have been in their contemplation as to the future, it is crystal clear that neither thought (when the partnership

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[7] In the *Ritter* case the Fourth Circuit Court of Appeals extended taxpayer's time to petition for rehearing because of the pendency of the *Culbertson* case; the petition, based on the Supreme Court's *Culbertson* decision, was denied July 6, 1949.

> agreement was signed) that the son would contribute anything to the partnership, either capital or services, during the tax year 1943, and that is what concerns us here.

See also *Scherf* v. *Commissioner,* 161 F. 2d 495, 498 (C.A. 5th), certiorari denied, 332 U. S. 810.

To be sure, in the *Culbertson* case (pp. 747-748), the Supreme Court indicated that an intra-family gift or sale of business capital may render the transferee the true owner, and hence a true partner for tax purposes, *if* the transferee exercises dominion and control over the transferred property by participating in management and influencing the conduct of the business. But it is clear from the Supreme Court's holdings in *Tower, Lusthaus* and *Culbertson* that neither the transfer, nor anticipated future services of the transferee, nor a combination of these features, compels the conclusion that the transferee is the true owner of the property and a true partner. That Congress never intended to recognize, for tax purposes, a family partnership erected upon an intra-family gift or sale of business capital is confirmed by the fact that amendments proposed by the Senate Finance Committee to the Revenue Bill of 1950 (H.R. 8920, 81st Cong., 2d Sess.), designed to accord partnership status to donees or vendees of partnership interests, were deleted from the Bill by the Conference Committee and never became a part of the Revenue Act of 1950.[8]

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[8] Section 222(a) of the Bill, added by the Senate Finance Committee (Amendment No. 110), would have amended Code Section 3797(a)(2), Appendix, *infra,* by adding the following:

> A person shall be recognized as a partner for income-tax purposes if he owns a capital interest in a partnership in which

Taxpayer's elaborate argument misconceives the plain tenor of the Supreme Court's holdings in the *Tower, Lusthaus* and *Culbertson* cases. Stripped to its essentials, his argument reduces itself to the contention, flatly rejected in the *Culbertson* case, that the Tax Court was obliged to conclude that both his children were partners during the taxable year merely because he sold portions of his capital to each with the expectation that one of them (his son) would contribute services in future years. Even if the argument were otherwise sound, it would have no relevancy as to the daughter.

B. *The Tax Court applied the correct principles.*

As is plain from its opinion, the Tax Court applied the principles enunciated in *Tower, Lusthaus*, and *Culbertson*. It did not, as taxpayer asserts (Br. 39-41), ignore the "reality test" prescribed in those cases. On the contrary, that is precisely the test it did apply. Quoting from the Supreme Court's opinion (p. 742),

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> capital is a material income producing factor, whether or not such interest is derived by purchase or gift from any other person.

Section 222(b) of the Bill would have added to the Code a new Section 191 so as to provide *inter alia*, that in the case of a "family partnership"—

> The fact that a partner does not actively participate in the management or conduct of the partnership business shall be taken into account in determining the proportionate value of services and capital, but shall not otherwise affect his status as a partner. For the purpose of this action, the term "family partnership" shall mean any partnership as defined in section 3797(a)(2) which includes two or more members of the same family as defined in section 24(b)(2)(D), and for this purpose a trust for the benefit of a member of a family shall be considered a member of such family.

These proposed amendments were stricken out by the Conference Committee. H. Conference Rep. No. 3124, 81st Cong., 2d Sess., pp. 1, 31.

the Tax Court addressed itself (R. 274) to the crucial question of "whether, considering all the facts * * * the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." After carefully analyzing all the evidence, including the agreement and conduct of the parties and the testimony, it answered that question in the negative. (R. 274-280.)

Since the question presented is one of fact, no single factor being conclusive, the Tax Court's determination should not be disturbed unless clearly erroneous. *Commissioner* v. *Culbertson, supra; Nordling* v. *Commissioner, supra; Barrett* v. *Commissioner* (C.A. 1st), decided November 13, 1950 (1950 C.C.H., par. 9501); *Morrison* v. *Commissioner,* 177 F. 2d 351 (C.A. 2d); *Morano* v. *Commissioner,* 175 F. 2d 555 (C.A. 3d), certiorari denied, 338 U. S. 904; *Eisenberg* v. *Commissioner,* 161 F. 2d 506 (C.A. 3d), certiorari denied, 332 U. S. 767; *Ritter* v. *Commissioner, supra; Scherf* v. *Commissioner, supra; Denison* v. *Commissioner,* 180 F. 2d 938 (C.A. 6th); *Appel* v. *Smith,* 161 F. 2d 121 (C.A. 7th); *Kohl* v. *Commissioner,* 170 F. 2d 531 (C.A. 8th), certiorari denied, 337 U. S. 956. "Whether the evidence would have supported a different finding by the Tax Court is a question not here presented." *Commissioner* v. *Tower, supra,* p. 280.

C. *The Tax Court's conclusion is amply supported by the record.*

The Tax Court's determination is clearly warranted by the record, especially in the light of the Supreme Court's admonition (*Commissioner* v. *Culbertson,*

supra, p. 744) that the absence of a contribution of new capital or of vital additional services or of a change in management "has the effect of placing a heavy burden of proof on the taxpayer to show the bona fide intent of the parties to join together as partners".

1. *No new capital.* Admittedly, no new capital was brought into the business by the admission of taxpayer's children as partners. What they proposed to invest as "partners" was but a part of the capital already invested in the business by taxpayer. In the words of the Supreme Court in the *Tower* case (p. 291), "No capital not available for use in the business before was brought into the business as a result of the formation of the partnership." The claimed partnership status of the children rests upon nothing more than taxpayer's "sale" to them of some of his capital, in exchange for notes secured by the very partnership interests sold to them and payable out of the shares of the profits attributed to them as partners. Insofar as the claimed capital contribution of the children is concerned, the instant case bears a striking resemblance to the *Lusthaus* case, where a husband sold a one-half interest in his capital to his wife in exchange for her promissory note payable out of the profits distributable to her as a partner. Indeed, the evidentiary support for the Tax Court's conclusion in this case is even stronger than in the *Lusthaus* case. There the vendee-wife also performed services during the taxable year, whereas here neither of the vendee-children did so. Moreover, there the wife had a substantial estate of her own which might have been subject to partnership debts, whereas here (R. 252-253)

the children had no separate property of their own. See also *Nordling* v. *Commissioner, supra; Houghland* v. *Commissioner, supra; Appel* v. *Smith, supra.*

There is no merit to taxpayer's contention (Br. 41-46, 50-51) that his sale of portions of his capital to the children, in exchange for notes payable out of the business profits, automatically made the children "true owners" of the transferred capital. The sale produced a shift of legal title from taxpayer to the children, not of economic ownership. The vendee-children no more became the real owners of the transferred capital than did the vendee-wife in the *Lusthaus* case, who acquired her interest in the same fashion as did taxpayer's children. To insist, as does taxpayer, that the children must be deemed partners for tax purposes by virtue of their purchase of some of his capital is to make the tax consequences turn on legal formalities rather than economic realities, and to adopt criteria of tax liability which are the very antithesis of those laid down in *Tower, Lusthaus* and *Culbertson.*

2. *No services.* Admittedly, the children contributed no services to the business during the taxable year, for they were absent from the business throughout that year. (Stip., R. 30-31.) The partnership agreement itself provided that taxpayer was to have "full charge of all business operations" (R. 262-263), and that the children "shall not devote any time or attention in carrying on said business unless hereafter agreed upon" (R. 264). At most, as the Tax Court pointed out (R. 275-276) and the facts recited by taxpayer show (Br. 18-20), the parties contemplated that taxpayer's son

and son-in-law would participate in the business in *future years.* This of course does not suffice to make either the son or the daughter a partner during the taxable year here involved. To establish a real partnership for tax purposes the taxpayer must show "participation in the business by the partners during the tax year. * * * The vagaries of human experience preclude reliance upon even good faith intent as to future conduct as a basis for the present taxation of income." *Commissioner* v. *Culbertson,* p. 740. See also *Ritter* v. *Commissioner, supra; Scherf* v. *Commissioner, supra.*

Taxpayer completely misconceives the Supreme Court's holding in the *Culbertson* case in contending (Br. 54-58) that the children must be deemed partners during the taxable year 1943 because of events which occurred in subsequent years. As for the son, until June of 1941 he was still attending college, and for the next six months he was a salaried employee. In January of 1942 he entered the Army, and he remained there until 1946. (R. 30-31, 251-252, 270-271.) Granting *arguendo* that one who has already become a partner in the tax sense does not cease to be one if his services to the business are interrupted by the military service, no such situation is here presented. The son's enlistment in the Army while he was a salaried employee, and the expectation of his future participation in the business after his discharge from the Army, did not operate to change his status from that of employee to partner. Substantially the same argument which taxpayer here is advancing with respect to the son was emphatically rejected by the Supreme Court in *Culbertson.* See also

Ritter v. *Commissioner, supra.* In the *Culbertson* case the Court stated (p. 739, fn. 6):

> Of course one who has been a bona fide partner does not lose that status when he is called into military or government service, and the Commissioner has not so contended. On the other hand, one hardly becomes a partner in the conventional sense merely because he might have done so had he not been called.

Even assuming (contrary to the holding in *Culbertson*) that the son must be deemed a partner in 1943 by reason of an expectancy of his future services, that scarcely furnishes any basis for taxpayer's insistence that his daughter must also be recognized as a partner. She was admitted in the hope that her husband—not she—would eventually participate in the business. (R. 253-254, 275-276.) The stipulated facts show that the daughter performed no services in 1943 or at any time thereafter. (R. 31.) Accordingly, even if taxpayer's argument were sound as to the son, it has no relevancy as to the daughter.

3. *No management participation.* In *Tower,* and again in *Culbertson* (p. 747), the Supreme Court indicated that a donee or vendee of business capital may become a true partner for tax purposes if he substantially participates in control and management of the business, "and through that control influences the conduct of the partnership." Here again no such situation is presented. The admission of the children as partners in no way influenced the conduct of the business during the taxable year. The business was carried on after

the formation of the partnership in the same way as before. The only difference was that portions of the profits previously distributable to taxpayer were credited to the children. The partnership agreement itself provided that taxpayer (R. 262-263)—

> shall be, and is from this date on made the general manager of said co-partnership, and that he shall be in full charge of all business operations of said co-partnership and that he shall have the full right to conduct the business of said co-partnership in such manner as he may desire, * * *

Pursuant to the agreement taxpayer continued to manage and conduct the business in the same manner as when he was its sole proprietor. In fact, neither child was available to participate in the conduct of the business, since the son was away in the Army and the daughter was living in Ohio. (R. 30-31, 251-252, 270-271.) What is more, taxpayer in his testimony acknowledged that he formed the partnership only in the hope of receiving the future services of his son and son-in-law. (R. 275-276.) Under the circumstances, the Tax Court was fully justified in finding (R. 270) that:

> During the year 1943 there was no change in the operation of United Packing Co. over prior years. The business was still completely under the control of Harkness, Sr.

Although taxpayer challenges (Br. 58-75) this finding, he points to nothing in the record which in any way detracts from it. He takes the position (Br. 68) that it was "natural and reasonable that the powers of management should be vested in" him, because the children

would be "absent for an indefinite period" and therefore unable to participate in the conduct of the business. That the children were unable to join together with taxpayer in carrying on the business as partners manifestly does not dispense with the requirement that they do so in order to be treated as partners for tax purposes. Nothing in the decisions or elsewhere warrants the assumption that the conditions precedent to tax recognition of a family partnership need not be met if they cannot be met. On taxpayer's theory even a new-born infant would have to be recognized forthwith as his father's "partner" for tax purposes, simply because the father transfers part of his capital to the child with the expectation that the child will some day participate in the business and assume the responsibilities of a partner.[9]

4. *No business purpose.* In *Culbertson* the Supreme Court stated (p. 742) that the ultimate factual question is whether the parties "acting with a business purpose intended to join together in the present conduct of the enterprise." The record fails to disclose any "business purpose" to be served by the admission of the children

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[9] In the *Culbertson* case the Supreme Court stated (p. 740, fn. 8):

> The *reductio ad absurdum* of the theory that children may be partners with their parents before they are capable of being entrusted with the disposition of partnership funds or of contributing substantial services occurred in *Tinkoff* v. *Commissioner,* 120 F. 2d 564, where a taxpayer made his son a partner in his accounting firm the day the son was born.

See also *Stanback* v. *Robertson, supra; Economos* v. *Commissioner, supra; Hash* v. *Commissioner, supra; Kohl* v. *Commissioner, supra; Eisenberg* v. *Commissioner, supra; Morano* v. *Commissioner, supra; Belcher* v. *Commissioner, supra; Dawson* v. *Commissioner, supra; Benson* v. *Commissioner, supra; Losh* v. *Commissioner, supra; Quon* v. *Commissioner, supra.*

as partners insofar as the "present conduct" of the business was concerned. At most, it shows that taxpayer transferred portions of his capital to his son and daughter in the hope that his son and the daughter's husband would in some future year contribute vital services. This may hardly be viewed as the equivalent of an intention to carry on business in partnership with the son and daughter during the taxable year 1943. *Commissioner* v. *Culbertson, supra,* pp. 738-740. Insofar as the business was concerned, nothing was added in that year. The only effect of the arrangement was to reallocate the business profits among the members of taxpayer's family.

Furthermore, the Tax Court found (R. 255-256), and it is undisputed, that taxpayer consulted a lawyer and was aware of the tax saving advantages he might gain by creating the partnership. While the tax saving objective was only a "secondary consideration" (R. 256), it is a relevant factor to be considered in determining whether the partnership was real. In any event, even if the arrangement was in no way motivated by tax avoidance objectives, the tax incidence would still flow from the economic substance of the arrangement irrespective of the underlying motives. *Hash* v. *Commissioner,* 152 F. 2d 722, 724 (C. A. 4th), certiorari denied, 328 U. S. 838; *Economos* v. *Commissioner,* 167 F. 2d 165, 167 (C. A. 4th), certiorari denied, 335 U. S. 826; *Nordling* v. *Commissioner, supra,* p. 704. Existence of a tax avoidance motive "simply lends further support to the inference" that the claimed partnership is unreal. *Commissioner* v. *Tower, supra,* p. 289.

5. *Income not distributed to children.* Cumulative support for the Tax Court's conclusion, if any were needed, is furnished by the fact that the shares of the profits ascribed to the children as partners were not distributed to them. The son's share was applied first to payment of the note he gave to taxpayer for his partnership interest, and the balance (except for $331 withdrawn in 1944) was retained in the business and credited to his capital account. (Ex. 6-F to Stip., R. 61; R. 271.) The daughter's share was also used to pay her note to taxpayer, and for taxes, and the small balance was used for personal expenditures. (Ex. 6-F to Stip., R. 65; R. 271.) Thus taxpayer retained the use and control of most of the income (as well as all of the capital) allocated to the children as partners. Even if all of the income attributed to the children had been distributed to them, the Tax Court would not have been bound to recognize them as partners, since the critical inquiry is who earned the income rather than who collects and spends it. See *Mauldin* v. *Commissioner,* 155 F. 2d 666 (C. A. 4th); *Helvering* v. *Clifford,* 309 U. S. 331. In short, the situation here is basically no different from any other where taxpayer diverts part of his income to a member of his family; he does not escape the tax whether the income in question is derived from services (*Lucas* v. *Earl,* 281 U. S. 111), or from property (*Helvering* v. *Clifford, supra; Commissioner* v. *Sunnen,* 333 U. S. 591), or, as here, from a blend of both sources (*Commissioner* v. *Tower, supra; Lusthaus* v. *Commissioner, supra; Commissioner* v. *Culbertson, supra*).

6. *Other factors.* The unreality of the arrangement is accentuated by a comparison of the value of the capital interests transferred by taxpayer to his children with the amount of profits credited to them as partners. The net worth of the business at the time of their admission as partners was $138,241, and the one-fourth share transferred to each was worth $34,560. (R. 258.) The profits allocated to the children for 1943 amounted to $71,645 each. (R. 271.) Thus within one year after the formation of the partnership, the share of the profits ascribed to each child as a partner amounted to more than 200 per cent of his or her so-called investment in the business, to say nothing of the fact that what the children purported to invest consisted of capital already in the business and that most of the profits allocated to them were left in the business. Moreover, since the children contributed no services whatever, all of the 1943 profits credited to them as partners represented a return upon their so-called investments. Such a partnership arrangement obviously is not one which would have been made by parties dealing at arm's length.

Under the circumstances, taxpayer failed to carry the "heavy burden" which rested upon him (*Commissioner* v. *Culbertson, supra,* p. 744), and the Tax Court's conclusion cannot be said to be clearly erroneous. Unless legal formalities are to prevail over economic realities, the conclusion is inescapable that the children became partners during 1943 in name and on paper only. The arrangement produced no change in the conduct of the business and the earning of its income, but merely an allocation to the children of a portion

of the business profits. "By the simple expedient of drawing up papers, single tax earnings cannot be divided into two tax units and surtaxes cannot be thus avoided." *Commissioner* v. *Tower, supra,* p. 291. See also *Commissioner* v. *Culbertson, supra.* As this Court stated in *Nordling* v. *Commissioner, supra,* p. 704, which involved a claimed husband-wife partnership, "In tax matters the realities of a transaction, not artificialities, are given effect." To hold that the Tax Court was obliged as a matter of law to accord tax effect to the instant arrangement would sanction the very type of formalism condemned by the Supreme Court in the *Tower, Lusthaus* and *Culbertson* cases, and by this and other Courts in a legion of other family partnership cases. See fns. 3 and 4, *supra.*

Even assuming *arguendo* that the children had contributed both original capital and vital services, it still would not follow, as taxpayer supposes, that these factors would be decisive of the intention of the parties to carry on business together as partners. *Commissioner* v. *Culbertson, supra; Morrison* v. *Commissioner, supra; Denison* v. *Commissioner, supra.* It would constitute but one of many relevant factors to be considered by the Tax Court in determining the real intent, and the Tax Court properly based its conclusion on the record as a whole.

Taxpayer points to no authority which calls for reversal of the decision below. Each case in this field turns, as it must, on its own facts. Although taxpayer relies chiefly upon the *Culbertson* case, it is plain from the opinion below that the Tax Court reached its decision here in the light of the principles enunciated in

that case. Indeed, the Supreme Court's opinion in that case, in and of itself, furnishes a complete refutation to taxpayer's contention that the Tax Court here committed reversible error. The case of *Greenberger* v. *Commissioner,* 177 F. 2d 990 (C.A. 7th), upon which taxpayer also strongly relies (Br. 49, 72-73), is not comparable on its facts. Compare the decisions of the same court in *Appel* v. *Smith, supra,* and *Tinkoff* v. *Commissioner,* 120 F. 2d 564. If any comparison is to be drawn between this and other cases, then we submit that this one bears a closer resemblance to the *Lusthaus* and *Culbertson* cases, and the numerous other family partnership cases (fn's 3 and 4) in which the Courts of Appeals have upheld the Tax Court's refusal to recognize the claimed partnership, than to those which taxpayer cites.

CONCLUSION

The decisions of the Tax Court are correct and should be affirmed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code:

Sec. 11. Normal Tax on Individuals.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a * * * tax * * *.

(26 U.S.C. 1946 ed., Sec. 11.)

Sec. 22. Gross Income.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U.S.C. 1946 ed., Sec. 22.)

Sec. 181. Partnership Not Taxable.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U.S.C. 1946 ed., Sec. 181.)

Sec. 182. Tax of Partners.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

(26 U.S.C. 1946 ed., Sec. 182.)

Sec. 3797. Definitions.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

*   *   *   *   *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture or organization.

*   *   *   *   *

(26 U.S.C. 1946 ed., Sec. 3797.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.22(a)-1. *What included in gross income.*—Gross income includes in general compensation for personal services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits and income derived from any source whatever, unless exempt from tax by law. (See sections 22(b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, * * *.

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